DOW THEORY LETTERS INC.

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THE MARKET: Pity the poor market letter writer. Everyone wants him to spell out in black and white exactly "what is going to happen," but the truth is that there are few times when he can be even reasonably certain of what lies ahead. During February, March and April I was as bearish as I have ever been, and I repeatedly apologized to subscribers for boring them with my warnings to "get out and stay out." Between February and October the market dropped 251 points. If you don't think that's a lot of pointage, you might remind yourself that the February to October drop wiped out 30% of the gains of the Industrial Average for the past 17 years. The damage to secondary and glamour issues was, for the most part, even worse.

In Letter 337 (October 12) I wrote, "Yes, I am fully aware that it does not make sense to increase one's bearishness as the market breaks to successively lower levels. Obviously every 10 points down is 10 points nearer the next important bottom. And the fact is that sooner or later we are going to get the first full upward correction, a correction which will probably retrace 1/3 to 2/3 of the ground lost since the February peak (995.15) in the Dow."

I feel that there is a 50/50 chance that we are now laying the base for a full correction of the 251 point 1966 drop. The question is, what should I tell my subscribers to do about it? For my "average" subscriber, I keep coming back to this: The overriding fact is that we are now in a primary bear market. The great tide of the market and the economy is receding. At times the force of the bear tide will be obvious and dramatic as during the successive selling waves of February-March, April-May, June-July and September-October of this year. At other times the waters will swirl back in deceptive counter-primary moves such as during March-April, May-June and most recently October-November. The point I want to make to my "average" subscriber is that a primary bear market will "break you if it can." Despite periodic rallies and retracements, a bear market represents a period of sickness, and if you insist on trying to make a sick man perform like a well one, you are probably going to see your hopes dashed before the game is over.

Now, for my veteran subscribers, traders and speculators I can tell you that I am watching for one particular development which I believe would be interesting (I touched on this

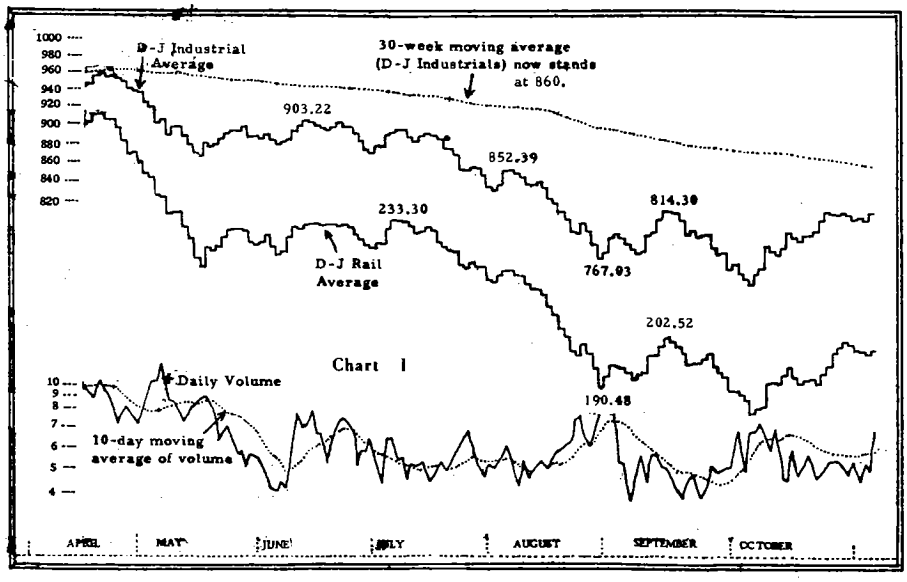
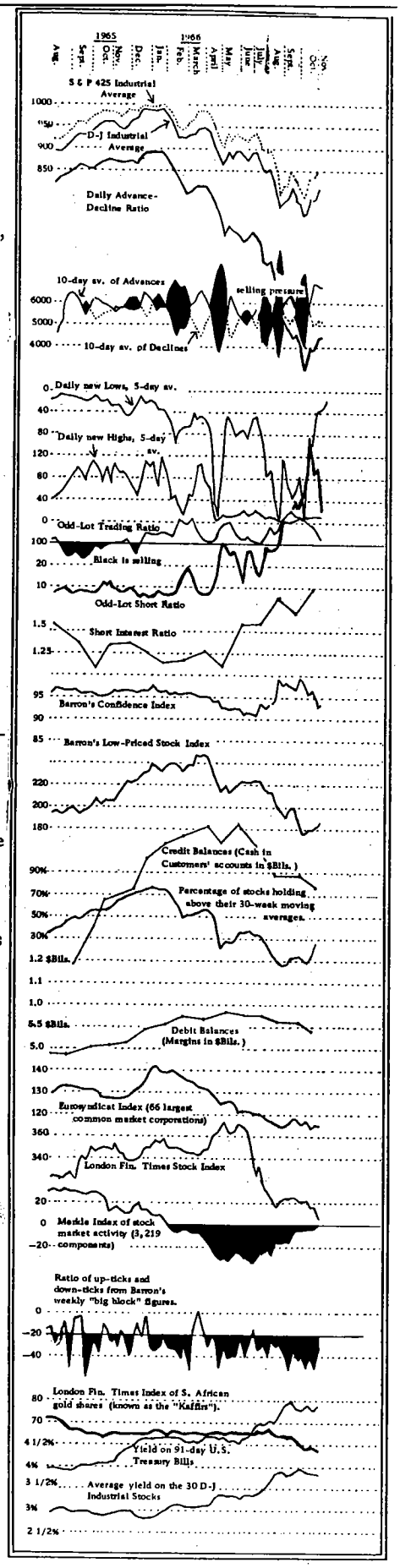


Chart I


1965
1966
S & P 425 Industrial Average
D-J Industrial Average
Daily Advance-Decline Ratio
10-day av. of Advances
selling pressure
10-day av. of Declines
Daily new Lows, 5-day av.
Daily new Highs, 5-day av.
Odd-Lot Trading Ratio
Black is selling
Odd-Lot Short Ratio
Short Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Credit Balances (Cash in Customers' accounts in $Bils.)
Percentage of stocks holding above their 30-week moving averages.
Debit Balances (Margins in $Bils.)
Eurosyndicat Index (66 largest common market corporations)
London Fin. Times Stock Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's weekly "big block" figures.
London Fin. Times Index of S. African gold shares (known as the "Kaffirs").
Yield on 91-day U.S. Treasury Bills
Average yield on the 30 D-J Industrial Stocks

briefly in recent Letters). I am looking for a possible new decline, a decline which could possibly be set off by some piece of unexpected bad news. The new decline would occur against a background of increasing odd-lot pessimism, and the decline might take the Dow to around the September low (around 760-780)and then stop. If so, we would have a fairly strong "bottoming formation" in the Dow, and such a structure could conceivably take the Dow back to the 850 to even the 900 area before it topped out.

What if the Dow continues on a straight up course from here -- without the decline as described above? In that case I would not buy into the move at all. What if the Dow backs off to say 770, consolidates (while we buy a few shares), and then tumbles to new lows? This is the chance traders have to take. If the Dow slides off to 770, and then consolidates as we buy some shares, and if it then starts sliding off again -- we would probably sell out and take our losses. At any rate, from the hopeful standpoint, there is a 50/50 chance that a full correction of the entire bear market is in the wind. Trading purchases executed during a minor new decline might work out satisfactorily. It's worth watching.

For the great majority of my subscribers, however, I want to say this. We are not playing this market for the short or even the intermediate term. We are investing with the primary trend for the long term, for a period of years -- not months. It has been my experience that the average person loses money when he attempts to "beat" the secondary trend. Those who sell out during bull market secondaries and then try to buy back for the next rise, usually lose out. The same thing is apt to occur during a bear market. Therefore, I say to the majority of my subscribers, you are out of this bear market now. You have avoided crushing losses during 1966. The odds are that you will do best if you refrain from speculative operations until this bear market is over. That is my opinion based on case history after case history.

For those subscribers who do not want to trade, for those who possess great patience, there is the consolation of knowing that in a year or so we will probably be in an area of great values. As the bad news emerges, as the public and the speculators go broke, as the new-comers suffer crushing losses, we will attempt to keep our own assets intact -- with one goal always in mind. That goal will be the investing of all available funds at the final, true bear market bottom.

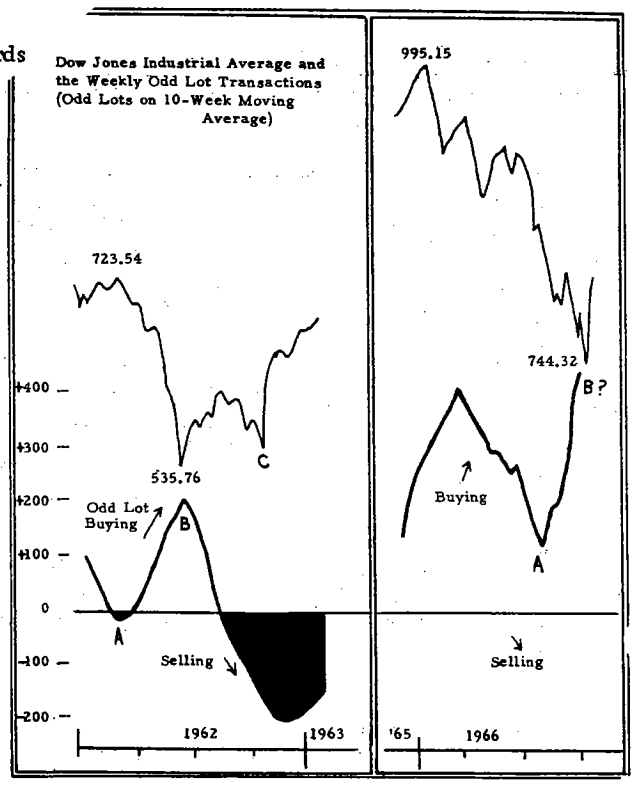
There, with yields on blue-chips at a probable 6% or better, we will have the opportunity of getting on the ground floor of the next primary bull market, with all the fortune-making possibilities that that implies. No, I don't think there are going to be "marvelous opportunities" on any rally from this area. I think that a rally from here could bring some people good profits and other losses (depending on how smart or lucky the particular individual is). So if you are eager but nervous, if you want action but are a bit timid, remember this: the market is always here. It's going to be here tomorrow and a year from tomorrow. And so often, the man who is patient, the man who can out-wait everyone else is the man who wins on Wall Street. The ancient Chinese proverb says, "All comes to him who waits."

ODD LOTS: The behavior of the public, as gauged by odd-lot transactions, can be extremely helpful in analyzing the trend of the market. The reason for this is the public tends to act in opposition to "investment money" at and around important turns. I have included a chart which is divided into two sections. The first section shows the odd-lot action during the 1962 crash and beyond. The second section follows the action during the current year 1966.

From February to June, 1962 (A to B on chart) the odd-lot public moved towards increased buying. The mistaken view was that "lower prices are bargains." At the crash lows of 535.76 (June), the market reversed and started higher. Here the odd-lotters embarked on their second incorrect change of sentiment. Following B the odd-lot public cut back steadily on their buying. By September, 1962, the odd-lots had switched from less buying to actual selling on balance (black area on chart).

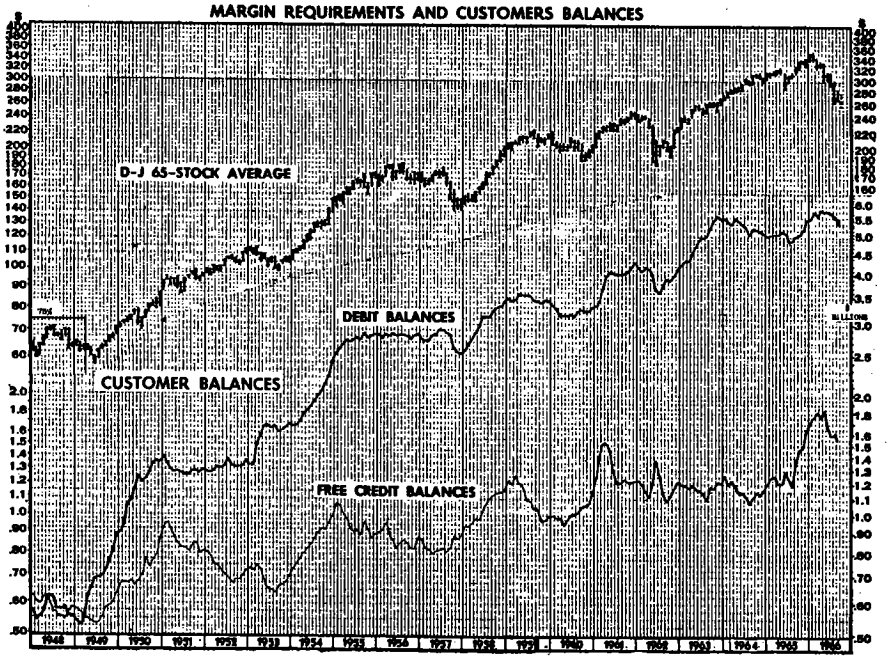
Now here is the important part. The odd-lot transactions gave their "buy signal" on the secondary decline into October (C on chart). Here we see a far different picture than existed at the first bottom at B. At B the odd-lots were increasing buying as the Dow declined. But at C (October) the odd-lots were panicking as the market declined. This picture of a declining Industrial Average in the face of increasing odd-lot selling provided the classic odd-lot buy signal.

The rationale at C is this. Note at C that the Dow refused to break the preceding June (535.76) bottom. On top of this the odd-lotters were selling heavily. What was going on? Evidently, large informed interests were accumulating or buying shares as fast as the odd-lotters sold them. The buying at C was sufficient to hold the Dow above the June lows, and an important odd-lot "buy signal" was thus rendered.



Now let us examine the action during 1966. Heavier buying occurred all during 1966 than was the case during 1962. As the 1966 decline gathered force, however, odd-lotters stepped up their buying (from A to B) just as they had done in 1962 (at A to B). On October 10 the Dow hit 744.32, then rallied violently. The question now is this: will odd-lotters undergo a change in sentiment during the period ahead? Are we currently in an area which corresponds to area B of 1962? If so, we can expect 10-week moving average of odd-lot transactions to turn down during the period ahead. Then, in the face of decreased odd-lot selling, the Dow should also decline in some sort of a "test" of the October, 1966 lows. Such action, decreased odd-lot buying (or actual selling) in the face of a declining Industrial Average, would suggest technical strength and the formation of a much more important bottom than now exists at the October lows.

But -- if the Dow declines over the period ahead and the odd-lotters step up their buying as the decline progresses, this will be a bearish omen. The odds, based on past history, suggest that important bases contain a structure wherein the odd-lot sentiment turns from hopefulness to fear in the face of declining prices. Such action has not yet been seen during the 1966 bear market. As judged from the odd-lot action since July, 1966, odd-lot sentiment has become increasingly optimistic. On the latest reading of the 10-week moving average the odd-lotters have , in fact, been buying stocks at the heaviest rate in four years.



DEBITS AND CREDITS: The trend of debit balances (cash in margin accounts) and credit balances (cash in customers' accounts) have a definite significance in analyzing the market trend. In general, the trend of credit balances corresponds with odd-lot activity. When the odd-lot public is buying on balance, they tend to draw down their cash accounts at the brokerage houses. Thus a steady drop in credit balances can be termed bearish for the market, for it means that the public is switching from cash to equity. Great areas of accumulation are usually characterized by selling (of stocks) on the part of the public. To this extent, dropping credit balances are a sign of technical deterioration.

Great interest was focussed on the rising credit balances during 1965. As so often happens when Wall Street pounces on a single technical indicator, that indicator goes "haywire." This occurred with credit balances during the 1965 period. Note on the accompanying chart that credit balances rose sharply from September, 1965 to May, 1966. Thus, despite the fact that customers' were building up cash in their account, the market was in a major "topping area." Following May the credit balances dropped rather sharply, however, thereby confirming the indications of the odd-lots (see odd-lot study in this Letter). All we can say about the credit balances, therefore, is that over the past 6 months they have declined with the market. Evidently, the public has been drawing off cash in its accounts and buying stocks, even though the market has been in a major primary bear phase. The current interpretation of the credit balances is bearish

Personally, I have always been more interested in the long-term implications of the debit balances. Carefully documented studies by my friend Dr. Sloan Wilson of Kansas (as detailed in his book, "The Speculator and the Stock Market") show that the debit user (i.e. the man who uses his margin) tends to be right in the market. The rationale for this is simple enough. It is the professional speculator who utilizes margin money, as opposed to the public which tends to pay cash for its stocks. In fact Dr. Wilson has stated repeatedly that the most important "tool" of the professional speculator is his margin account.

Studies of all bull and bear markets since 1929 indicate that the margin user increases his account as a bull market progresses. This is normal, since the professional is well aware of the fortune making opportunities in a primary bull market, and he is simply expanding his speculative activities in harmony with the bull trend. Thus on the chart we see that total debits rose from the $.5 billion area of 1949 (when the last bull market began) to the $6 billion of April, 1966. But here is the interesting part. Wilson has shown that during a primary bear market debit balances decrease, and they continue to shrink during the entire course of the bear market. At the final bottom of every bear market since 1929, states Wilson, debit balances have returned to the levels at which the preceding bull market began. Thus at the bottom of a bear market the speculator finally is "defeated." His margin account is back to the levels at which the previous bull market began. His urge to speculate has evaporated.

And what of stocks at a bear market bottom? Stocks have once again returned to the vaults of the hard-core investors. There is no speculation, no excitement, no need for margins at the bear market lows. The only buyers at the bottom are the seasoned investors, the accumulators of true values. And they do not need or want margins. They are buying high-yielding investment stocks at bargain prices -- and they are buying them for cash. Margin is the furthest thing from their minds.

The chart shown here is drawn to semi-logarithmic or ratio scale. It shows percentages of change. From the standpoint of percentages, the long-term decline in debit balances has just begun. Even the whopping $247 million drop in debits over the latest period shows up as a "blip" on the chart. But if this is to be a long bear market here is what we can expect. We can expect to see margins drop lower and lower until finally (perhaps in 2 or 3 years) debit balances will be back in the area of $.5 to $1 billion. At that point we will be able to say that even the professional speculator has finally been beaten. The men who speculate on margin will have left Wall Street to lick their wounds. Thus, the long-term direction and level of margin accounts will be one of the gauges we will use to try to call the final bottom area of the current primary bear market.

As an added note of interest, it is probable that the quarter billion drop in margins of last month represents part of the first stage in the beating which margin holders are fated to take before this bear market is over. This first beating undoubtedly was brought on by the collapse in the high-flyers and glamour shares. But there is also a long list of other issues which have lost 40% to 60% of their value during 1966. And there will be more lists of battered issues before margins have finally been squeezed dry, and before the final bottom is reached.

ELECTION RESULTS: I take the results as a mild rebuke of the Administration and Great Society efforts. But I believe that the straw is in the wind. By the time of the Presidential elections of 1968, I believe the current mild rebuke will have developed into a full-grown violent national protest. Bear markets breed discontent; discontent is almost always translated into running incumbent politicians out of office.

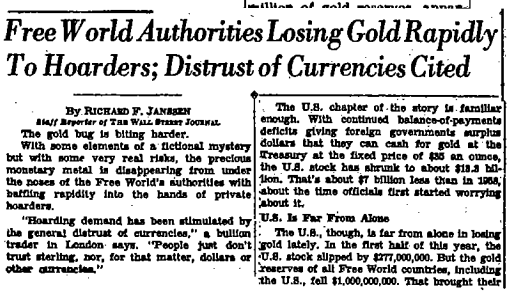
GOLD: The stocks have gone into major corrections, but the fundamentals are still there. I enclose two significant news-clips, and I was particularly interested in the Egyptian predicament. The translation of this clip is, "when the chips are down, you can talk anything you want but your international creditors will believe gold." And that is what Mr. Nasser has found out, as he sells the wealth of Egypt to try to keep his profligate administration afloat. For 5,000 years politicians have tried to do away with gold; for 5,000 years they have ultimately lost each battle with the yellow metal. Personally, I am holding my 10% "hedge" in gold shares.

Cairo Sells $25-Million of Gold To Alleviate Financial Squeeze

Special to The New York Times

CAIRO, Oct. 27—The Government of the United Arab Republic, beset by an acute foreign exchange squeeze and an unfavorable balance of trade, recently sold about $25-million of gold backing for Egyptian currency, informed sources said today.

The latest statement of the Central Bank of Egypt, issued today, shows the sale of $18.4-



Free World Authorities Losing Gold Rapidly To Hoarders; Distrust of Currencies Cited

By RICHARD F. JANSSEN
Staff Reporter of THE WALL STREET JOURNAL.

The gold bug is biting harder.

With some elements of a fictional mystery but with some very real risks, the precious monetary metal is disappearing from under the noses of the Free World's authorities with baffling rapidity into the hands of private hoarders.

"Hoarding demand has been stimulated by the general distrust of currencies," a bullion trader in London says. "People just don't trust sterling, nor, for that matter, dollars or other currencies."

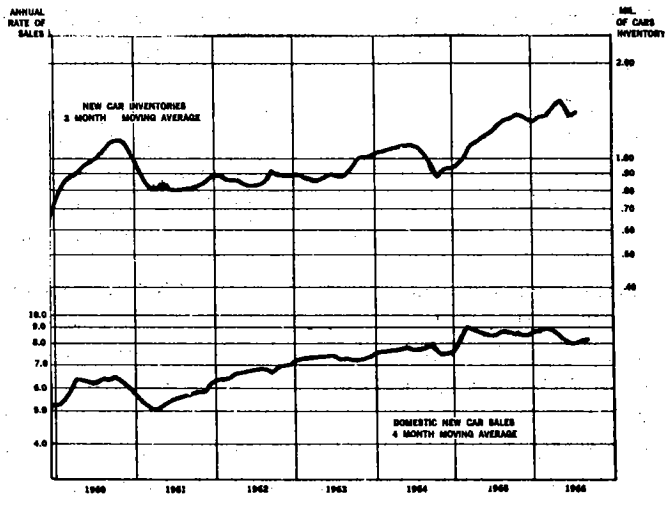
The U.S. chapter of the story is familiar enough. With continued balance-of-payments deficits giving foreign governments surplus dollars that they can cash for gold at the Treasury at the fixed price of $35 an ounce, the U.S. stock has shrunk to about $13.3 billion. That's about $7 billion less than in 1958, about the time officials first started worrying about it.

U.S. Is Far From Alone

The U.S., though, is far from alone in losing gold lately. In the first half of this year, the U.S. stock slipped by $277,000,000. But the gold reserves of all Free World countries, including the U.S., fell $1,000,000,000. That brought their

STOCKS: I have just gone through hundreds of daily and weekly charts. In general, it is surprising to see how few stocks are in "basing formations," and those that are do not seem to have formed bases which compare in power with the potential base in the Dow (see chart 1).

Particularly bothersome to me is the activity in auto stocks. Last week GM touched a 3-year low in relative strength (as did Chrysler), while Ford's relative strength line sank to a 6-year low. The dismal performance of the giant auto stocks is almost sure to reflect disappointing auto sales and profits during 1967. A slow-down in auto sales (one out of every seven jobs in the nation is connected with auto manufacturing and sales) is not calculated to help the American economy in general. By next year I feel that the impending slow-down in autos will be felt in almost every sector of the business world.



A few groups do show up as standouts, and these are Drugs, Oils, Motion Pictures and Utilities. Among the drug stocks Pfizer, Schering, American Home Products look strong. In Movies it is MGM and 20th Century. Outstanding oils are Standard of Indiana, Gulf, Texaco. Traders might assume a position in one or two stocks in each of these groups on any decline from this area. But again I want to emphasize that those who are willing to trade in this market are in the position of being strict speculators. They should be fully aware of the risks involved in buying into a secondary reaction in a confirmed primary bear market. They must be ready to "kick out" speculative purchases and move to the sidelines in the event of renewed important weakness following a decline wherein they assume trading positions.

CHART OF THE WEEK: The chart at right (Cleveland Trust) is self-explanatory. It is saying that either the current rate of car sales must rise or current auto production must be reduced.